

July 2010

# DEPARTMENT OF DEFENSE

## Additional Actions Needed to Improve Financial Management of Military Equipment



Report Documentation Page				Form Approved OMB No. 0704-0188	
Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.					
1. REPORT DATE <b>JUL 2010</b>		2. REPORT TYPE		3. DATES COVERED <b>00-00-2010 to 00-00-2010</b>	
4. TITLE AND SUBTITLE <b>Department of Defense: Additional Actions Needed to Improve Financial Management of Military Equipment</b>				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) <b>U.S. Government Accountability Office, 441 G Street NW, Washington, DC, 20548</b>				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT <b>Approved for public release; distribution unlimited</b>					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT <b>Same as Report (SAR)</b>	18. NUMBER OF PAGES <b>48</b>	19a. NAME OF RESPONSIBLE PERSON
a. REPORT <b>unclassified</b>	b. ABSTRACT <b>unclassified</b>	c. THIS PAGE <b>unclassified</b>			



Highlights of [GAO-10-695](#), a report to congressional committees

## Why GAO Did This Study

Major defense acquisition programs (MDAP) are used to acquire, modernize, or extend the service life of the Department of Defense's (DOD) most expensive assets, primarily military equipment. The Weapon Systems Acquisition Reform Act of 2009 (P.L. 111-23), section 304(b), directed us to perform a review of weaknesses in DOD's operations that affect the reliability of financial information for assets acquired through MDAP. To do so, GAO identified and reviewed previously reported weaknesses that impair DOD's ability to provide reliable cost information for military equipment acquired through MDAPs, and determined what actions DOD has taken to address them. GAO searched databases of audit reports issued during calendar years 2005 through 2009 to identify previously reported weaknesses. Using applicable criteria, GAO assessed whether the actions taken by DOD adequately addressed these weaknesses.

## What GAO Recommends

GAO is making 11 recommendations intended to strengthen actions DOD has taken to begin improving its ability to identify, aggregate, and account for the cost of military equipment acquired through MDAPs. Specifically, our recommendations focused on the need to define departmentwide cost accounting requirements and develop the process and system capabilities needed to support cost accounting and management. DOD concurred with our recommendations.

[View GAO-10-695 or key components.](#)  
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## DEPARTMENT OF DEFENSE

### Additional Actions Needed to Improve Financial Management of Military Equipment

## What GAO Found

GAO found that weaknesses that impaired the department's ability to identify, aggregate, and account for the full cost of military equipment it acquires comprised seven major categories. Specifically, DOD had not (1) maintained support for the existence, completeness, and cost of recorded assets; (2) structured its contracts at the level of detail needed to allocate costs to contract deliverables; (3) provided guidance to help ensure consistency for asset accounting; (4) implemented monitoring controls to help ensure compliance with department policies; (5) defined departmentwide cost accounting requirements; (6) developed departmentwide cost accounting capabilities; and (7) integrated its systems.

Although the department has acknowledged that it is primarily focused on verifying the reliability of information, other than cost, recorded in its property accountability systems, DOD has begun actions to address these weaknesses and improve its capability to identify, aggregate, and account for the full cost of its military equipment. For example, DOD is requiring that acquisition contracts be structured in a manner that facilitates application of the appropriate accounting treatment for contract costs, including the identification of costs that should be captured as part of the full cost of a deliverable. In addition, it has also begun to require that all contract deliverables that meet defined criteria be assigned a unique item identifier to facilitate asset tracking and aggregation of costs, and that electronic contract-related documentation, such as the invoice and receipt/acceptance documents, be maintained in a central data repository to ensure the availability of supporting documentation. Moreover, the department has begun to identify cost accounting data elements within its Standard Financial Information Structure (SFIS) and requires that its business-related Enterprise Resource Planning (ERP) systems support this structure. These efforts are intended to improve data sharing and integration between business areas.

DOD acknowledged that the actions taken to date do not yet provide the department with the capabilities it needs to identify, aggregate, and account for the full cost of its military equipment. For example, DOD has begun to develop ERPs but has not yet defined the cost accounting requirements to be used to evaluate if these ERPs will provide the functionality needed to support cost accounting and management. DOD stated that additional actions, sustained management focus, and the involvement of many functional groups across DOD are needed before weaknesses that impair its ability to account for the full cost of the military equipment it acquires are addressed. Until DOD defines its cost accounting requirements and completes the other actions it has taken (e.g., defining data elements in SFIS) to support cost accounting and management, DOD is at risk of not meeting its financial management objective to report the full cost of its military equipment. DOD has stated that until these actions are completed it will continue to rely on its military equipment valuation (MEV) methodology to estimate the cost of its military equipment for financial reporting purposes.

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United States Government Accountability Office  
Washington, DC 20548

July 26, 2010

## Congressional Committees

For years, GAO and other entities have reported on weaknesses that affect the Department of Defense's (DOD) ability to effectively manage its major defense acquisition programs (MDAP).<sup>1</sup> Since 2003, DOD's portfolio of MDAPs has increased steadily from 77 to 98 and the cumulative estimated investment in these programs has grown from approximately \$1.2 trillion to \$1.7 trillion.<sup>2</sup> MDAPs are used to acquire, modernize, or extend the service life of some of the department's most expensive assets, primarily military equipment such as aircraft, ships, tanks, and self-propelled weapons.<sup>3</sup> Although MDAPs can include any major acquisition program that meets the dollar or other criteria necessary for MDAP designation, DOD officials stated that approximately 75 percent of the total number of MDAPs reported in July 2009 are likely to involve the acquisition of military equipment assets. While the department has reported over a trillion dollars in its military equipment investments on its financial statements, DOD acknowledged that the department lacks the process and

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<sup>1</sup>MDAPs are programs that are estimated by the Under Secretary of Defense for Acquisition, Technology, and Logistics to require an eventual total expenditure for research development, test, and evaluation of more than \$365 million, including all planned increments, based on fiscal year 2000 constant dollars (approximately \$509 million in fiscal year 2010 dollars); \$2.190 billion of procurement funding, including all planned increments (approximately \$3.054 billion in fiscal year 2010 dollars); or are designated as a major defense acquisition program by the milestone decision authority. See DOD Instruction 5000.02, *Operation of the Defense Acquisition System* (Dec. 2, 2008); Under Secretary of Defense (AT&L), Memorandum, Subject: *Directive-Type Memorandum (DTM) 09-027 - Implementation of the Weapon Systems Acquisition Reform Act of 2009* (Dec. 4, 2009).

<sup>2</sup>This represents a 42 percent increase in fiscal year 2009 dollars. Fiscal year 2010 information will be available after September 30, 2010.

<sup>3</sup>Military equipment are weapon systems that can be used directly by the Armed Forces to carry out battlefield missions.

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system capabilities to reliably identify, aggregate, and report the full cost of these assets.<sup>4</sup>

Given the magnitude of DOD's military equipment assets and the inherent risk associated with managing large acquisition programs, having reliable and timely cost information is essential for proper planning and effective management and oversight. In August 2009, the DOD Comptroller directed that the department focus its limited financial management improvement resources and efforts on identifying and addressing weaknesses in areas deemed most useful to DOD managers. Specifically, the Comptroller prioritized efforts focused on ensuring the reliability of the department's budgetary information and property accountability records for mission critical assets, which includes military equipment. The DOD Comptroller stated that many difficult problems remain unresolved—including implementing compliant systems and valuing the department's significant investment in property, plant, and equipment—and will require the involvement of many functional groups across DOD.

The Weapon Systems Acquisition Reform Act of 2009 (Pub. L. No. 111-23), section 304(b), directed us to perform a review of weaknesses in DOD's operations that affect the reliability of financial information on assets acquired through MDAPs. Our objective was to identify previously reported weaknesses that impair DOD's ability to provide reliable cost information for military equipment acquired through MDAPs and determine what actions DOD has taken to address them. This report provides the results of our review. The act also requires our office to review the growth in operating and support costs of major weapon systems. We are issuing a separate report in response to that provision of the act.

To address the objective, we searched databases of audit reports issued during calendar years 2005 through 2009 using key terms (e.g., military equipment) to identify weaknesses in business operations that impair DOD's ability to account for the cost of military equipment based on

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<sup>4</sup>Full cost is the sum of direct and indirect costs. Direct costs are costs that can be specifically identified with an output, including salaries and benefits for employees working directly on the output, materials, supplies, and costs with facilities and equipment used exclusively to produce the output. Indirect costs are costs that are not specifically identifiable with any output and may include costs for general administration, research and technical support, and operations and maintenance for buildings and equipment. See Statement of Federal Financial Accounting Standards (SFFAS) 4, "*Managerial Cost Accounting Standards and Concepts*" (Washington, D.C.: July 31, 1995).

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relevant federal financial accounting standards.<sup>5</sup> We grouped the weaknesses into categories. We discussed with DOD officials the categories of weaknesses identified and obtained supporting documentation—such as memorandums, directives, and an independent validation and verification report for the military equipment valuation initiative—on their actions to address them. Using applicable criteria,<sup>6</sup> we assessed whether the actions taken adequately addressed the identified weaknesses. To obtain clarification and explanations, as needed, we interviewed key department officials. Our detailed audit scope and methodology are presented in appendix I. We conducted this performance audit from October 2009 through July 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We requested comments on a draft of this report from the Secretary of Defense or his designee. Written comments from the Office of the Under Secretary of Defense (Comptroller) are reprinted in appendix II.

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## Background

DOD has acknowledged that process and system weaknesses impair its ability to account for the full cost of military equipment and that these weaknesses impede its ability to achieve financial statement auditability. DOD is required by various statutes to improve its financial management processes, controls, and systems to ensure that complete, reliable, consistent, and timely information is prepared and responsive to the

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<sup>5</sup>Statement of Federal Financial Accounting Standards (SFFAS) 4: “*Managerial Cost Accounting Standards and Concepts*” (Washington, D.C.: July 31, 1995); SFFAS 6: *Accounting for Property, Plant, and Equipment*, (Washington, D.C.: Nov. 30, 1995, as amended); SFFAS 8: *Supplementary Stewardship Reporting* (Washington, D.C.: June 11, 1996, as amended); SFFAS 23, *Eliminating the Category National Defense Property, Plant, and Equipment* (Washington, D.C.: May 2003); and SFFAS 35, *Estimating the Historical Cost of General Property, Plant, and Equipment—Amending Statements of Federal Financial Accounting Standards 6 and 23* (Washington, D.C.: Oct. 14, 2009).

<sup>6</sup>See for example, SFFAS 4; SFFAS 6; SFFAS 8; SFFAS 23; SFFAS 35; GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999); Institute of Electrical and Electronics Engineers, Inc., *Recommended Practice for Software Requirements Specifications*, IEEE Std. 830-1998 (New York, N.Y.: June 25, 1998) and *Guide for Information Technology—System Definition—Concept of Operations (ConOps) Document*, IEEE Std. 1362-1998 (New York, N.Y.: Mar. 19, 1998, reaffirmed Dec. 5, 2007); and Software Engineering Institute, *Capability Maturity Model Integration for Development*, Version 1.2 (Pittsburgh, Pa.: August 2006).

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information needs of agency management and oversight bodies, and to produce annual audited financial statements prepared in accordance with generally accepted accounting principles (GAAP) on the results of its operations and its financial position.<sup>7</sup> Federal accounting standards, which are GAAP for federal government entities, require that the full cost of outputs (e.g., military equipment assets acquired) be reflected on agencies' financial statements.<sup>8</sup> As stated earlier, full cost is the sum of direct and indirect costs to produce the output.<sup>9</sup> The standards require that the cost of property, plant, and equipment, which includes military equipment, shall include all costs incurred to bring the asset to a form and location suitable for its intended use.<sup>10</sup> Examples of these costs include amounts paid to vendors; labor and other direct or indirect productions costs; and direct costs of inspection, supervision, and administration of construction contracts and construction work<sup>11</sup>. Federal accounting standards allow reporting entities to use reasonable estimates of historical cost to value their property, plant, and equipment while encouraging them to establish adequate controls and systems to reliably capture asset costs in the future.<sup>12</sup>

DOD is also required by law to provide, at least annually, Selected Acquisition Reports (SARs) to congressional defense committees on the status of its MDAPs.<sup>13</sup> SARs are the primary means by which DOD reports

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<sup>7</sup>These statutes include the Chief Financial Officers Act, the Government Management Reform Act of 1994, the Federal Financial Management Improvement Act of 1996, and various annual authorization and appropriations act provisions.

<sup>8</sup>SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board* (Washington, D.C.: July 28, 2009); and SFFAS 4.

<sup>9</sup>SFFAS 4.

<sup>10</sup>SFFAS 6.

<sup>11</sup> Each of these costs may be funded through different appropriations or other accounts, so recognizing and recording the full cost of an asset may involve more than the costs recorded an MDAP budgetary account that covers an individual MDAP asset.

<sup>12</sup>SFFAS 35.

<sup>13</sup>DOD is required to submit SARs to Congress at the end of each fiscal year quarter on current major defense acquisition programs, although certain exceptions apply. SARs for the first quarter of a fiscal year are known as comprehensive annual SARs. Each comprehensive annual SAR is required to be submitted within 60 days after the date on which the President transmits the budget to Congress for the following fiscal year. 10 U.S.C. § 2432(b)(1), (c)(4), (f).



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the status of these programs to Congress. These reports are intended to provide Congress the information needed to perform its oversight functions. In general, SARs contain information on the cost estimates, schedule, and performance of a major acquisition program in comparison with baseline values established at program start. Specific information contained in the SARs includes:

- program description, including the reasons for any significant changes in the total program cost for development and procurement reported in the previous SAR;
- schedule milestones;
- quantity of items to be purchased;
- procurement unit cost;<sup>14</sup>
- contractor costs (initial contract price, the current price, and the price at completion); and
- technical and schedule variances.

Congressional reporting through the SAR ceases after 90 percent of the items related to a particular MDAP have been delivered to the government, or after 90 percent of the planned expenditures under the program or subprogram have been made. After the program reaches the 90 percent threshold, the items are no longer categorized as MDAPs and enter what is referred to as the sustainment period in which the cost of the units are categorized as Operations and Support. A program can be redesignated as an MDAP if planned modifications or upgrades to an asset meet the criteria for MDAP designation.

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<sup>14</sup>Equals the total of all funds programmed to be available for obligation for procurement for the program, divided by the number of fully configured end items to be procured.

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## DOD Has Actions Underway to Address Financial Management Weaknesses Related to Military Equipment, but Additional Actions Are Needed

Our review of prior reports, studies, and analyses to identify weaknesses in DOD's operations identified the following seven categories of weaknesses that impaired the department's ability to account for the cost of military equipment: (1) support for the existence, completeness, and cost of recorded assets is needed; (2) more detail is needed in DOD contracts to allocate costs to contract deliverables; (3) additional guidance is needed to help ensure consistency for asset accounting; (4) monitoring is needed to help ensure compliance with department policies; (5) departmentwide cost accounting requirements need to be defined; (6) departmentwide cost accounting capabilities need to be developed; and (7) systems integration is needed.

DOD has begun actions to address these previously reported weaknesses; however, it acknowledges that additional actions are needed before these weaknesses are fully addressed. DOD officials—including the Deputy Director, Financial Improvement and Audit Readiness (FIAR) Directorate, Office of the Under Secretary of Defense (Comptroller), and the Deputy Director of Property and Equipment Policy within the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics (AT&L)—stated that the size and complexity of the department's operations make it difficult to reach consensus on how best to address the weaknesses. They acknowledged that the department is currently focused on verifying the reliability of information, other than cost, recorded in its property accountability systems. These officials told us that until the department fully addresses the weaknesses that prevent it from accurately and completely accounting for the cost of its military equipment, it will continue to rely on a methodology to estimate the cost of its military equipment assets for financial reporting purposes. The availability of timely, reliable, and useful financial information on the full costs associated with acquiring assets is an essential tool that assists both management and Congress in effective decision making such as determining how to allocate resources to programs. It also provides an important monitoring mechanism for evaluating program performance that can help strengthen oversight and accountability.

The seven categories of weaknesses and DOD's actions to address them are as follows.

Support for the existence, completeness, and cost of recorded assets is needed. DOD has not maintained the documentation needed to support the existence, completeness, and full cost of its military equipment assets. There were instances in which the department could not (1) trace assets recorded in its property accountability systems to actual physical assets,

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or (2) locate the records supporting the actual physical assets. Further, for assets included in the accounting system, DOD could not substantiate that all costs (e.g., acquisition, freight, inspection, and modification) had been captured and reported because of the lack of documentation (e.g., invoices). Standards for internal control call for transactions and other significant events to be accurately and timely recorded, as well as clearly documented, with the documentation being readily available for examination.<sup>15</sup> In addition, DOD policy requires that the components maintain all financial records documenting the acquisition of property, plant, and equipment in support of the department's Records Management Program.<sup>16</sup> The components are also required to establish and maintain the Records Management Program, as well as periodically evaluate compliance. DOD stated that it has three ongoing initiatives to address this weakness—the military equipment valuation (MEV), the Proper Financial Accounting Treatment for Military Equipment (PFAT4ME), and the Wide Area Work Flow (WAWF).

As allowed by federal accounting standards,<sup>17</sup> DOD is using its MEV methodology to estimate the historical cost of its military equipment assets. The MEV methodology uses a combination of available data (budgetary and expenditure) to estimate the historical cost of military equipment assets. These estimated values were reported on the department's fiscal year 2006 through 2009 financial statements. However, the results of several DOD Inspector General (IG) audits and an evaluation by the Under Secretary for AT&L identified implementation issues that impaired the reliability of the derived cost estimates in part, because DOD was unable to provide documentation to substantiate the universe of

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<sup>15</sup>[GAO/AIMD-00-21.3.1.](#)

<sup>16</sup>DOD Financial Management Regulation Volume 1, Chapter 9, *Financial Records Retention* (April 2009); and DOD Directive 5015.2, *DOD Records Management Program* (Mar. 6, 2000).

<sup>17</sup>Statement of Federal Financial Accounting Standards (SFFAS) 35, *Estimating the Historical Cost of General Property, Plant, and Equipment—Amending Statements of Federal Financial Accounting Standards 6 and 23* (Washington, D.C.: Oct. 14, 2009); SFFAS 23, *Eliminating the Category National Defense Property, Plant, and Equipment* (Washington, D.C.: May 2003); and SFFAS 6: *Accounting for Property, Plant, and Equipment* (Washington, D.C.: Nov. 30, 1995, as amended).

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assets subject to its valuation methodology.<sup>18</sup> For example, both reported that, in some cases, assets were included in the valuation that no longer existed, and assets that existed were improperly excluded from the valuation.

To address these concerns, in 2009 DOD initiated efforts—primarily physical inventories—to verify the reliability of information recorded in its property accountability systems. In May 2010, the DOD Comptroller issued guidance for the performance of the physical inventories and internal control testing.<sup>19</sup> This guidance states that the components should verify critical information, such as individual item identifier, category/asset type, location, condition, utilization rate, and user organization. It also identifies the need to perform internal control testing. However, it does not specifically require verification that a unique identifier has been assigned to the asset and recorded in the Item Unique Identification (IUID) registry<sup>20</sup> as required by DOD policy.<sup>21</sup> The guidance also does not provide specific guidance to perform tests of internal controls (e.g., does not identify which controls to test or how to do so). DOD officials, including the Deputy Director, Financial Improvement and Audit Readiness (FIAR) Directorate, Office of the Under Secretary of Defense (Comptroller) agreed with our assessment. The FIAR Deputy Director further stated that

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<sup>18</sup>Department of Defense, Office of the Inspector General, *Internal Controls Over the Department of the Navy Military Equipment Baseline Valuation Effort*, D-2009-008 (Arlington, Va.: Oct. 31, 2008); *Memorandum Report on Internal Controls Over the U.S. Special Operations Command Military Equipment Baseline Valuation Effort*, D-2008-103 (Arlington, Va.: June 13, 2008); *Memorandum Report on Internal Controls Over the Air Force Military Equipment Baseline Valuation Effort*, D-2008-074 (Arlington, Va.: Apr. 1, 2008); Air Force Military Equipment Baseline Valuation, F2007-0009-FB3000 (Washington, D.C.: May 29, 2007); Military Equipment Baseline—Electronic Pods, F2007-0003-FB3000 (Washington, D.C.: Jan. 19, 2007); Financial Management: Report on Development of the DOD Baseline for Military Equipment, D-2005-114 (Arlington, Va.: Sept. 30, 2005); Financial Management: Report on the Review of the Development of the DOD Baseline for Military Equipment, D-2005-112 (Arlington, Va.: Sept. 30, 2005); and the Department of Defense, Property and Equipment Policy, Office of Undersecretary of Defense for Acquisition, Technology, and Logistics, Internal Validation and Verification Project: Military Equipment Valuation (June 13, 2006).

<sup>19</sup>DOD, Fiscal Year 2010 Financial Improvement and Audit Readiness (FIAR) Guidance (May 15, 2010).

<sup>20</sup>The IUID Registry is the central repository for IUID information that captures specific information on the acquired item (e.g., what the item is, how and when it was acquired, and the initial unit cost of the item).

<sup>21</sup>Department of Defense Instruction 5000.02, Operation of the Defense Acquisition System (Dec. 8, 2008).

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it is difficult to provide specifics on the internal control testing to be performed in the above guidance so the department intends to establish a 2-day training course by the summer of 2010 that will provide instruction on how to identify and test controls. DOD plans to complete the verification of the existence and completeness of its military equipment property accountability records in fiscal year 2015.<sup>22</sup> Previously estimated military equipment values reported on its financial statements will be reassessed upon completion of verification efforts at each military department.

In addition, the department issued its PFAT4ME policy in June 2006 that requires all contracts be structured at the level of detail needed to provide supporting documentation regarding the cost of individual items delivered.<sup>23</sup> The contract-related documentation (e.g., invoices, and receipt and acceptance documents) received electronically that results from performance of a contract is then to be input into a central repository within the WAWF, which became operational in fiscal year 1999, where it is maintained and available to help support full cost determinations. However, these efforts do not adequately address this weakness because they do not address the lack of supporting documentation for noncontract-related costs such as program management costs incurred. As stated earlier, DOD policy requires components to maintain supporting documentation for the full cost of acquired military equipment assets; however, DOD has not enforced components' compliance with its record management policy. Because it does not have the needed supporting documentation, the department has to rely on an estimation methodology to derive these assets' values.

More detail is needed in DOD contracts to allocate costs to contract deliverables. DOD had not structured contracts at the level of detail needed to identify and assign costs to individual military equipment assets. Specifically, the contracts were not structured in a manner that facilitated application of the appropriate accounting treatment for costs, including the identification of those costs that should be captured as part of the full cost of a deliverable. Standards for internal control require that the agency

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<sup>22</sup> According to DOD's Comptroller, Air Force plans to complete efforts to verify the existence and completeness of its military equipment property accountability records in 2011, followed by Navy in 2013, and Army in 2015.

<sup>23</sup> Under Secretary of Defense for Acquisition, Technology, and Logistics memorandum, *Proper Accounting Treatment for Military Equipment* (June 30, 2006).

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identifies, captures, and distributes information at the sufficient level of detail that permits management to carry out its roles and responsibilities.<sup>24</sup> DOD stated that the PFAT4ME and the Item Unique Identification (IUID) initiatives will address this weakness. PFAT4ME requires program managers to structure all contracts entered into after October 2006 in a manner to facilitate the appropriate accounting treatment of contract costs.<sup>25</sup> To implement this initiative, DOD developed a training course on how to comply with the requirements outlined in its PFAT4ME policy.<sup>26</sup> However, it is not a core or required course and DOD has not established a process to ensure that acquisition personnel affected by this policy, including program managers and business/financial management analysts, complete the course.

In 2009, AT&L began to perform oversight activities to verify that the components were properly structuring the contracts; however, AT&L officials stated that they were not verifying whether program management offices were appropriately accounting for the cost of each deliverable. In addition, we found that DOD has not developed guidance for these oversight activities, including how often these reviews are to be performed, roles and responsibilities for this oversight, the steps to be performed, and the basis for selecting contracts for review.

In addition, DOD policy requires contract deliverables, including military equipment, that meet predefined criteria, be assigned a unique item identifier.<sup>27</sup> According to DOD officials responsible for the IUID initiative, the purpose of the unique item identifier is to facilitate asset

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<sup>24</sup> [GAO/AIMD-00-21.3.1](#).

<sup>25</sup> Under Secretary of Defense for Acquisition, Technology, and Logistics memorandum, *Proper Accounting Treatment for Military Equipment* (June 30, 2006).

<sup>26</sup> The course is entitled Structuring Procurement Requests to Facilitate Proper Financial Accounting Treatment for Military Equipment and is available through the Defense Acquisition University.

<sup>27</sup> Under Secretary of Defense for Acquisition, Technology, and Logistics, DOD Instruction 8320.04, *Item Unique Identification (IUID) Standards for Tangible Personal Property* (June 16, 2008), requires that an item unique identifier be applied to an item if one or more of the following criteria are met: (1) the item has a unit acquisition cost of \$5,000 or more; (2) the item has a unit acquisition cost of less than \$5,000 and is identified by the requiring activity as DOD serially managed, mission essential, or controlled inventory; (3) the item has a unit acquisition cost of less than \$5,000 and the requiring activity determines that permanent identification is required; and (4) regardless of value, (a) any DOD serially managed subassembly, component, or part embedded within an item and (b) the parent item that contains the embedded subassembly, component, or part.

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accountability and tracking, including the identification and aggregation of related costs to derive the full cost of a contract deliverable.<sup>28</sup> The department expected to fully implement IUID by fiscal year 2015; however, according to DOD officials, the department is not on target for achieving its timeline. These officials told us that the department has encountered difficulty in obtaining consensus from the components in implementing this initiative primarily due to the applicability of the IUID requirement to controlled inventory items. The Deputy for Program Development and Implementation, Defense Procurement and Acquisition Policy within AT&L explained that controlled inventory items—which encompass items such as ammunition and threaded fasteners and number in the hundreds of millions—were never intended to be assigned individual unique item identifiers. The department is currently in the process of clarifying this requirement.<sup>29</sup> DOD has determined that if it does not modify the IUID policy to eliminate this requirement, it will not be able to fully implement IUID until fiscal year 2023. If the IUID requirements are revised to exclude these items, DOD expects to fully implement IUID by 2017. DOD officials acknowledged that they have not yet developed policies and procedures that define how IUID will be used to identify and aggregate asset costs.

Additional guidance is needed to help ensure consistency for asset accounting. DOD had not developed a policy and procedures requiring the components to account for the full costs of military equipment assets. Standards for internal control call for agencies to develop and implement appropriate policies, procedures, techniques, and mechanisms to ensure that management's directives are consistently carried out.<sup>30</sup> DOD stated that the PFAT4ME, IUID, and the MEV methodology will address this weakness. AT&L officials, including the Deputy Director of Property and Equipment Policy, told us that they are working with the Federal Accounting Standards Advisory Board's Accounting and Auditing Policy Committee (AAPC) to develop full cost guidance. They also noted that AT&L has drafted guidance intended to supplement its PFAT4ME policy memorandum to assist managers in identifying the types of contract costs that should be included in determining the full cost of an asset, such as military equipment. According to these officials, this policy has not been

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<sup>28</sup>Under Secretary of Defense for Acquisition, Technology, and Logistics, DOD Instruction 5000.02, *Operation of the Defense Acquisition System* (Dec. 8, 2008).

<sup>29</sup>DOD Instruction 8320.04.

<sup>30</sup>[GAO/AIMD-00-21.3.1](#).

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finalized because the department has had difficulty reaching consensus regarding its cost accounting requirements. These officials stated that this draft guidance does not yet address noncontract-related costs, such as program management costs incurred directly by the military services and indirect costs. They did not provide a time frame for completing these efforts.

As stated earlier, the department is currently relying on an estimation methodology referred to as MEV to report the cost of its military equipment. In order for management and auditors to rely upon the results of the methodology it is important that the methodology be implemented consistently. To help ensure consistency in the application of its estimating methodology, DOD developed business rules in 2005. In addition to the MEV implementation issues identified by the DOD IG, we identified inconsistencies in the business rules for estimating the cost of military equipment, which further impact the reliability of reported estimates. For example, the MEV full cost business rule states that all costs incurred to acquire and bring military equipment to a form and location for its intended use should be capitalized, including the direct costs of maintaining the program management office. However, the MEV program management office business rule states that program management office costs are immaterial and should be expensed. DOD officials agreed that there are inconsistencies in the business rules and acknowledged the need to revisit them.

Monitoring is needed to help ensure compliance with department policies. DOD has not established adequate monitoring controls to assess compliance with applicable policies or the extent to which actions taken are achieving their intended objectives. For example, although DOD property accountability policies and regulations require DOD components to (1) perform periodic physical inventories and to reconcile the results to the associated property accountability records, and (2) track and maintain records for all government-furnished property in the possession of contractors, DOD management has not established needed monitoring controls to help ensure compliance. Standards for internal control require agencies to develop and implement ongoing monitoring activities over the internal control system to ensure adherence with policies and procedures.<sup>31</sup> DOD financial management and AT&L officials, including the Deputy Director of Property and Equipment Policy within AT&L, stated

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<sup>31</sup> [GAO/AIMD-00-21.3.1](#).



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that weaknesses in the department's ability to ensure compliance with property accountability requirements have impacted its ability to substantiate reported military equipment costs. As a result of the breakdowns in compliance with policies and regulations for recording and tracking property, property records used by the components for valuing its military equipment included assets that no longer existed, and did not include other assets that did exist. To address this concern, DOD is in the process of verifying its property accountability records by conducting physical inventories and internal control testing. As stated earlier, DOD has issued guidance, but it does not provide specifics as to the internal control testing to be performed. The DOD Comptroller told us that the department plans to complete this effort in fiscal year 2015. After completing this effort, effective ongoing monitoring activities are needed to ensure departmentwide compliance with policies designed to help maintain reliable property accountability records.

Departmentwide cost accounting requirements need to be defined. DOD has not defined its requirements for the identification and aggregation of cost information, which will be the foundation for its development of departmentwide cost accounting and management capabilities. Federal accounting standards require that the full cost of resources, which directly or indirectly contribute to the production of outputs (e.g., military equipment acquired), be reflected on an agency's financial statement. To ensure that costs are identified and accumulated in a consistent and comparable manner, entities should define their requirements and procedures for identifying, measuring, analyzing, and reporting costs.<sup>32</sup> Since DOD has stated that it intends to support the identification, aggregation, accounting, and reporting of cost information through the implementation of the Enterprise Resource Planning (ERPs)<sup>33</sup>, it is important that DOD define its cost accounting requirements to ensure that these systems provide these capabilities. Institute of Electrical and Electronics Engineers (IEEE)<sup>34</sup> and the Software Engineering Institute at Carnegie Mellon recommend that organizations define their requirements,

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<sup>32</sup> SFFAS 4 and 6.

<sup>33</sup> ERPs are automated systems that utilize commercial off-the-shelf (COTS) software consisting of multiple, integrated functional modules that perform a variety of business-related tasks such as payroll, general ledger accounting, and supply chain management.

<sup>34</sup> The IEEE is a nonprofit, technical professional organization that develops standards for a broad range of global industries, including the information technology and information assurance industries, and is a leading source for defining best practices.

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which are the specifications that system developers and program managers use to develop or acquire, implement, and test a system.<sup>35</sup> This process should identify user requirements, as well as those needed for the definition of the system. It is critical that requirements be carefully defined and that they reflect how the organization's day-to-day operations are or will be carried out to meet mission needs. Improperly defined or incomplete requirements have been commonly identified as a root cause of system failure and systems that do not meet their cost, schedule, or performance goals. DOD Comptroller and Business Transformation Agency officials stated that the implementation of the ERPs and its Standard Financial Information Structure (SFIS) are intended to address this weakness. Comptroller and Business Transformation Agency and military department financial management and comptroller officials stated that most of the ERPs under development within the military departments have cost accounting management capabilities inherent in their design as required by DOD policy.<sup>36</sup>

Although agencies should first define their requirements, which are then used to evaluate the system's capabilities to determine if it will meet users' needs before it is developed or acquired, the department has not yet defined its cost accounting requirements at the major component level, including how SFIS will be used to support cost accounting in the existing and ERP system environments. They stated that the department has been unable to reach consensus on how to implement SFIS in support of cost accounting and management. SFIS is intended to be a comprehensive "common business language" that will standardize the financial reporting of information and data for budgeting, financial accounting, and cost/performance management. DOD has not yet determined how the SFIS data elements will be used to identify and aggregate cost information, nor has it established time frames for developing the cost accounting requirements and completing SFIS.

Departmentwide cost accounting capabilities need to be developed. DOD had not developed departmentwide cost accounting capabilities to capture military equipment asset costs. Federal accounting standards require agencies to develop and implement cost accounting systems that provide

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<sup>35</sup>IEEE Std 830-1998 and 1362-1998; and Software Engineering Institute, *Capability Maturity Model Integration for Development*, Version 1.2 (Pittsburgh, Pa.: August 2006).

<sup>36</sup>DOD, Financial Management Regulation, Volume 4, Chapter 19, *Managerial Cost Identification* (May 19, 2010).

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the capability to collect cost information by responsibility segments, measure the full cost of outputs, provide information for performance measurement, integrate cost accounting and general financial accounting, provide appropriate and precise information, and accommodate special cost-management needs.<sup>37</sup> DOD's legacy financial management and related business systems were not designed to meet current financial reporting requirements and do not provide adequate evidence for supporting material amounts on the financial statements or acquisition management decision making. These systems were designed to record and report information on the status of appropriations and support funds management, and not designed to collect and record financial information in compliance with federal accounting standards. DOD acknowledged that it does not yet have the capability to identify, aggregate, and capture the full costs of its military equipment and has stated that the ERPs are intended to provide this capability.

We have previously reported on problems that DOD has encountered in its efforts to implement ERPs. In 2007, we reported that the Army lacked an integrated approach for implementing its ERPs, which could result in interoperability problems.<sup>38</sup> In September 2008, the Army reported a similar finding.<sup>39</sup> Specifically, the Army reported that interoperability problems were likely to occur due to the lack of common data definitions and structures between the Army's ERPs—General Fund Enterprise Business System (GFEBS), Global Combat Support System-Army (GCSS-Army), and Logistics Modernization Program (LMP)—thus resulting in the need for manual reconciliations and reduced efficiencies. The report concluded that the planned configuration of these systems may prevent the Army from receiving the intended benefits of an ERP, including financial transparency and cost accounting. Army officials stated that they are addressing these deficiencies, but did not provide a time line for completion. In July 2009, Navy reported that its ERP did not yet provide the capability to aggregate cost information to derive the full cost of its military equipment and to segregate military equipment from other general

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<sup>37</sup>SFFAS 4.

<sup>38</sup>GAO, *Defense Business Transformation: A Comprehensive Plan, Integrated Efforts, and Sustained Leadership Are Needed to Assure Success*, [GAO-07-229T](#) (Washington, D.C.: Nov. 16, 2006).

<sup>39</sup>U.S. Army Program Executive Office Enterprise Information Systems, *U.S. Army ERP Phase III Analysis Decision Brief* (Sept. 26, 2008).

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property, plant, and equipment.<sup>40</sup> The Navy Financial Management Officer stated that these deficiencies have not yet been addressed because of other priorities. DOD stated that ERPs are critical to transforming business operations within the military departments.

Systems integration is needed. DOD had not fully integrated its property and logistics systems with acquisition and financial systems. DOD policy requires that its financial management systems are planned for and managed together, operated in an integrated fashion, and linked together electronically in an efficient and effective manner to provide reliable, timely, and accurate financial management information.<sup>41</sup> The department's property and logistics systems were not designed to capture acquisition costs and the cost of modifications and upgrades, or to calculate depreciation. Many of the financial management systems in use are not fully integrated with other systems within the military components or departmentwide. The number of system interfaces and subsidiary and feeder systems, and the lack of standard data elements employed by each DOD component, make it difficult to cross-walk data between systems, share data, and ensure consistency and comparability of data. In March 2009, DOD reported that its legacy system environment does not facilitate the identification and aggregation of the full cost of its assets.<sup>42</sup> DOD officials, including the Deputy Director of Property and Equipment Policy, AT&L, stated that the implementation of the ERPs and SFIS is intended to address this weakness. To facilitate information sharing for financial reporting purposes, in August 2005 DOD issued a policy requiring systems, including ERPs, that contain financial information to provide the ability to capture and transmit information following the SFIS data structure or, if not, to demonstrate that this capability will be achieved through a cross-

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<sup>40</sup>Science Applications International Corporation/Eagan, McAllister, Associates, Inc., *Gap Analysis Study: NAVAIR Management of Operation Materials and Supplies, General Equipment, and Military Equipment in Navy ERP* for the Department of the Navy Financial Improvement Program, Naval Air Systems Command (Lexington Park, Md.: July 31, 2009).

<sup>41</sup> DOD Financial Management Regulation, Volume 1, Chapter 3, *Federal Financial Management Improvement Act of 1996 Compliance, Evaluation, and Reporting* (October 2008); and DOD Directive 5000.01, *The Defense Acquisition System* (May 12, 2003) certified current as of November 20, 2007. Financial management systems include the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.

<sup>42</sup>DOD, *Financial Improvement and Audit Readiness Plan (FIAR Plan)* (Mar. 30, 2009).

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walk to the SFIS data structure.<sup>43</sup> DOD components and agencies are required to report to the Business Transformation Agency (BTA) the extent to which SFIS requirements, as defined in the department's business enterprise architecture, are met. BTA officials, including the official responsible for the SFIS initiative, stated that the department is developing a process to validate the information included in the SFIS compliance reports submitted by the components and agencies but did not provide a time frame for completion. However, if certain SFIS requirements, such as cost accounting, are not clearly defined, including a determination of how cost information should be identified, aggregated, and managed within and across acquisition programs, the department's intent to achieve standardization and comparability of cost information will be at risk. Further, as stated above, the Army's ERPs—GFEBS, GCSS-Army, and LMP—may experience interoperability problems because of the lack of common data definitions and structures. In addition, DOD stated that it has not yet determined whether or how WAWF and the IUID will be integrated into the emerging ERP environment to facilitate the identification and aggregation of cost to address the agency's requirements.

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## Conclusions

While DOD is relying on a methodology to estimate the cost of its military equipment, the department has various actions underway to begin laying a foundation for addressing weaknesses that currently impair its ability to identify, aggregate, and account for the full cost of its military equipment assets. For example, DOD has taken important steps such as requiring greater detail in contract-related documentation, such as invoices, and the assignment of unique identifiers to individual items to aid its ability to identify, aggregate, and account for the cost of acquired assets. An additional challenge that DOD faces is establishing the universe of assets subject to valuation and cost accounting. Previous audits and evaluations have showed that some assets that no longer existed were included while other existing assets were improperly excluded from DOD's property accountability records. This situation exists due to a combination of issues, including gaps in DOD's guidance and policies related to asset accountability, as well as a lack of compliance with existing policies and guidance. These examples illustrate the interconnection or dependency between the various asset accounting issues the department is facing and

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<sup>43</sup>Department of Defense Memorandum, *Standard Financial Information Structure (SFIS) Implementation Policy* (Aug. 4, 2005).

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its related actions to improve its cost accounting financial management for military equipment. DOD has acknowledged that additional actions are needed before the department achieves cost accounting and management capabilities, but stated that its improvement efforts are not yet focused on achieving these capabilities. Additional efforts are needed to issue additional guidance regarding how to identify the full cost of an asset to supplement its PFAT4ME guidance and to identify and define departmentwide cost accounting requirements at the major component level, including what information is needed to manage cost within and across acquisition programs and support asset valuation and life-cycle management and how implementation of SFIS and the ERPs will support these requirements. Moreover, DOD needs to determine the extent to which certain actions currently underway, such as WAWF and IUID, will be utilized in the emerging ERP environment. Without additional actions and guidance, the department's current efforts are at risk of not meeting the intended objectives of providing cost accounting capabilities needed to reliably account for and report the full cost of its military equipment.

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## Recommendations

In order to enhance corrective actions underway within DOD to address previously reported weaknesses and improve DOD's ability to provide reliable information on the full cost of military equipment acquired through MDAPs, we recommend that the Secretary of Defense direct the DOD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense for Acquisition, Technology, and Logistics; and the military department Chief Management Officers, as appropriate, to take the following nine actions:

- Enforce compliance with the department's records management policy by periodically evaluating the extent to which the components are maintaining documentation in support of the full cost of military equipment.
- Establish and implement ongoing monitoring activities to enforce compliance with the department's existing policies and procedures requiring the components to (1) perform periodic physical inventories and to reconcile the results to property accountability records after completion of existing efforts to verify the reliability of the property accountability records and (2) track and maintain records for government-furnished property in the possession of contractors.
- Update the department's guidance regarding verification of information in component property accountability records to include

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verification that all assets recorded in the accountability records that are required by DOD to have a Unique Item Identifier are included in its IUID registry.

- Develop and implement guidance on how the IUID will be used to identify, aggregate, and report asset cost information.
- Classify the PFAT4ME training as a core course for the department's affected acquisition personnel, including program managers, and track attendance to ensure that such personnel take the training.
- Develop and implement guidance to help ensure compliance with the oversight activities for the PFAT4ME initiative, including how often these reviews are to be performed, roles and responsibilities for oversight, the steps to be performed, and the basis for selecting contracts for review.
- Complete efforts to develop and implement a policy requiring the components to account for the full cost of military equipment, including guidance for what types of contract and other costs should be included and for determining the appropriate accounting treatment of these costs.
- Review the MEV methodology business rules to identify inconsistencies and revise the rules as needed.
- Assess the WAWF and IUID initiatives and determine the extent to which they will be utilized in the emerging ERP business systems environment.

Additionally, we recommend that the Secretary of Defense direct the military department Chief Management Officers, in consultation with the Under Secretary of Defense (Comptroller) and the Under Secretary of Defense for Acquisition, Technology, and Logistics, as appropriate, take the following two actions:

- Define the cost accounting requirements at the major component level, including how SFIS data elements will be used to identify, aggregate, account for, and report cost information.
- After defining the cost accounting requirements, utilize the requirements as input to the ERPs to help ensure that the ERPs will provide the capability to identify and aggregate cost information for

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the department's assets in accordance with DOD's defined requirements.

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## Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Under Secretary of Defense (Comptroller) which are reprinted in Appendix II. In commenting on the report, the Under Secretary stated the department agreed with the need to establish a framework that provides improved cost and management information that will support better management of Major Defense Acquisitions Programs (MDAP). The department concurred with the 11 recommendations and cited actions taken, under way, or planned to address them.

In its response, the department emphasizes that it is sensitive to the cost of obtaining information solely for the purpose of proprietary financial reporting or audit compliance where this information is not otherwise used by management. It further states that DOD has concluded that it is not cost-effective to gather auditable data on the historical cost of military equipment systems for proprietary financial reporting and audit because the information is not used to manage. DOD has indicated that it will propose changes in department policies and instructions to accommodate this decision. These pending policy changes will likely impact DOD's implementation of our recommendations and so at some point we may need to assess DOD's corrective actions under the changed policies to determine whether the actions meet the intent of our recommendations.

DOD acknowledges that there may be requirements for cost information related to acquisition-program lifecycle management, which the department will accommodate as appropriate. DOD also stated that it is working with federal standard setters to develop full-cost guidance that would guide its cost accounting efforts. The department will integrate this guidance into the ERPs and guide cost accounting efforts and will develop, coordinate, and issue policy and guidance on accounting for the full cost of military equipment consistent with our recommendations. We welcome DOD's decision to accommodate such requirements and contribute to revised guidance for cost-effectively serving management's information needs and reliable reporting on the cost of acquisition programs and assets acquired.

It is also important to note that while federal accounting standards do not require agencies to collect historical, transaction-based cost data, they encourage agencies that estimate asset value, such as DOD, to establish the internal control practices and systems needed to capture and sustain



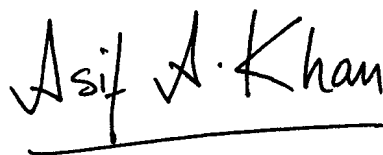
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such data for future acquisitions. We believe that this guidance reflects the importance of actual costs in providing reliable historical information for accountability to the American taxpayer and for management decision making as well. It is important to emphasize that our recommendations are focused not on gathering costs retrospectively but are intended to assist DOD in its efforts to develop the processes and systems needed to produce reliable information going forward. We believe that providing reliable information is likely to include capturing transaction-based costs as historical information for future management decisions and accountability reporting.

The availability of timely, reliable, and useful financial information on the costs associated with acquiring assets is an essential tool that assists both management and Congress in effective decision making such as determining how to allocate resources to programs. It also provides an important monitoring mechanism for evaluating program performance that can help strengthen oversight and accountability.

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We are sending copies of this report to interested congressional committees; the Secretary of Defense; the Secretaries of the Army, the Navy, and the Air Force; the Deputy Secretary of Defense/Chief Management Officer; the Under Secretary of Defense (Comptroller)/Chief Financial Officer; the Under Secretary of Defense for Acquisition, Technology, and Logistics; the Under Secretary of the Army/Chief Management Officer; the Under Secretary of the Navy/Chief Management Officer; the Under Secretary of the Air Force/Chief Management Officer; and the Office of Management and Budget's Office of Federal Financial Management. This report is available at no charge on GAO's Web site at <http://www.gao.gov>. Should you or your staff have any questions concerning this report, please contact me at (202) 512-9095 or [khana@gao.gov](mailto:khana@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

A handwritten signature in black ink that reads "Asif A. Khan". The signature is written in a cursive style with a horizontal line underneath the name.

Asif A. Khan  
Director, Financial Management and Assurance

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*List of Committees*

The Honorable Carl Levin  
Chairman  
The Honorable John McCain  
Ranking Member  
Committee on Armed Services  
United States Senate

The Honorable Daniel Inouye  
Chairman  
The Honorable Thad Cochran  
Ranking Member  
Subcommittee on Defense  
Committee on Appropriations  
United States Senate

The Honorable Ike Skelton  
Chairman  
The Honorable Howard McKeon  
Ranking Member  
Committee on Armed Services  
House of Representatives

The Honorable Norman D. Dicks  
Chairman  
The Honorable C.W. Bill Young  
Ranking Member  
Subcommittee on Defense  
Committee on Appropriations  
House of Representatives

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# Appendix I: Objective, Scope, and Methodology

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Our objective was to identify previously reported weaknesses that impair the Department of Defense's (DOD) ability to provide reliable cost information for military equipment acquired through major defense acquisition programs (MDAPs)<sup>1</sup> and determine what actions DOD has taken to address them.

To address this objective, we obtained an understanding of MDAPs, including the military equipment (i.e., weapon systems) assets acquired through such programs, by reviewing DOD guidance and interviewing officials from the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics.<sup>2</sup> We identified and reviewed applicable federal financial accounting standards, and interviewed officials of the Federal Accounting Standards Advisory Board to obtain clarification on the changes made to Statement of Federal Financial Accounting Standards (SFFAS) 35.<sup>3</sup> We searched databases of audit reports issued during calendar years 2005 through 2009 using key terms (e.g., military equipment; general property, plant, and equipment; financial management;

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<sup>1</sup>MDAPs are programs that are estimated by the Under Secretary of Defense for Acquisition, Technology, and Logistics to require an eventual total expenditure for research development, test, and evaluation of more than \$365 million, including all planned increments, based on fiscal year 2000 constant dollars (approximately \$509 million in fiscal year 2010 dollars); \$2.190 billion of procurement funding, including all planned increments (approximately \$3.054 billion in fiscal year 2010 dollars); or are designated as a major defense acquisition program by the milestone decision authority. See DOD Instruction 5000.02, *Operation of the Defense Acquisition System* (Dec. 2, 2008); Under Secretary of Defense (AT&L), Memorandum, Subject: *Directive-Type Memorandum (DTM) 09-027 - Implementation of the Weapon Systems Acquisition Reform Act of 2009* (Dec. 4, 2009).

<sup>2</sup>The guidance reviewed included DOD Directive 5000.01, *The Defense Acquisition System*, (May 12, 2003); DOD Instruction 5000.02, *Operation of the Defense Acquisition System* (Dec. 2, 2008); DOD Instruction, 8320.04, *Item Unique Identification (IUID) Standards for Tangible Personal Property* (June 16, 2008); DOD Instruction 8320.04, *Item Unique Identification (IUID) Standards for Tangible Personal Property* (June 16, 2008); DOD Instruction 5000.64, *Accountability and Management of DOD-Owned Equipment and Other Accountable Property* (Nov. 2, 2006); and the Undersecretary of Defense for Acquisition, Technology, and Logistics Memorandum, *Proper Financial Accounting Treatment for Military Equipment* (June 30, 2006).

<sup>3</sup>Statement of Federal Financial Accounting Standards (SFFAS) 4: *Managerial Cost Accounting Standards and Concepts* (Washington, D.C.: July 31, 1995); SFFAS 6: *Accounting for Property, Plant, and Equipment* (Washington, D.C.: Nov. 30, 1995, as amended); SFFAS 8: *Supplementary Stewardship Reporting* (Washington, D.C.: June 11, 1996, as amended); SFFAS 23, *Eliminating the Category National Defense Property, Plant, and Equipment* (Washington, D.C.: May 2003); and SFFAS 35, *Estimating the Historical Cost of General Property, Plant, and Equipment—Amending Statements of Federal Financial Accounting Standards 6 and 23* (Washington, D.C.: Oct. 14, 2009).

weapons systems acquisition; and major defense acquisition programs).<sup>4</sup> We reviewed the results of our search (e.g., reports, studies, and analyses) to identify weaknesses in business operations that, based on relevant federal financial accounting standards, impair DOD's ability to account for the cost of military equipment. We grouped these weaknesses into categories. To identify additional reports or relevant DOD studies and analyses and to obtain clarification, as needed, on reported weaknesses, we interviewed key department officials, including the following:

- Deputy Director, Financial Improvement and Audit Readiness Directorate, Office of the Under Secretary of Defense (Comptroller);
- Acting Deputy Director, Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics;
- representatives from the DOD's Inspector General Office;
- representatives from the military services' offices of the Assistant Secretary, Financial Management and Comptroller, Financial Management Operations; and
- Chief Management Office representatives within DOD and the military services as required by section 304(b).

See appendix III for the reports, studies, and analyses reviewed to identify the relevant weaknesses.

We discussed with DOD officials the categories of weaknesses we identified as a result of our search of prior reports, studies, and analyses, and obtained supporting documentation—such as memorandums, directives, an independent validation and verification report for the military equipment valuation initiative, and gap analyses related to the Navy Enterprise Resource Planning effort—from DOD on its actions to address them. Using applicable criteria,<sup>5</sup> we assessed whether the actions taken adequately addressed the identified weaknesses. We interviewed the DOD officials referred to above to obtain clarification and explanation of

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<sup>4</sup>Audit report databases searched were those of GAO, the DOD Inspector General, the Naval Audit Service, the U.S. Army Audit Agency, and the Air Force Audit Agency.

<sup>5</sup>See for example, SFFAS 4, SFFAS 6, SFFAS 8, SFFAS 23, SFFAS 35; GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999); Institute of Electrical and Electronics Engineers, Inc., *Recommended Practice for Software Requirements Specifications*, IEEE Std. 830-1998 (New York, N.Y.: June 25, 1998) and *Guide for Information Technology—System Definition—Concept of Operations (ConOps) Document*, IEEE Std. 1362-1998 (New York, N.Y.: Mar. 19, 1998, reaffirmed Dec. 5, 2007); and Carnegie Mellon Software Engineering Institute, *Capability Maturity Model Integration for Development*, Version 1.2 (Pittsburgh, Pa.: August 2006).

actions taken to address the weaknesses, including mechanisms and metrics used to monitor progress.

We conducted this performance audit from October 2009 through July 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# Appendix II: Comments from the Department of Defense



COMPTROLLER

UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

JUL 13 2010

Mr. Asif A. Khan  
Director, Financial Management and Assurance  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Khan:

This is the Department of Defense (DoD) response to the Government Accountability Office (GAO) draft report GAO-10-695, "DEPARTMENT OF DEFENSE: Additional Actions Needed to Improve Financial Management of Military Equipment," dated June 15, 2010 (GAO Code 197089). Detailed comments are enclosed with this letter.

The Department has begun laying a foundation for addressing weaknesses that currently impair our ability to identify, aggregate, and account for the full cost of military equipment assets. The Chief Management Officer is working with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the military department Chief Management Officers as appropriate to define Department-wide cost accounting requirements and develop the process and system capabilities needed to support better cost accounting and management.

At the same time, the Department is sensitive to the cost of obtaining information solely for purposes of proprietary financial reporting or audit compliance where this information is not otherwise used by management. As recognized in your report, this is consistent with our current Financial Improvement/Audit Readiness (FIAR) priorities that focus specifically on "Existence and Completeness" for military equipment. The Department has assessed the costs and associated benefits of reporting and auditing property cost information in financial statements and will finalize a business case with the results. The policies that are addressed in this audit report should provide cost-effective management information when future target systems have been implemented, capturing cost information as a byproduct of business processes.

DoD agrees with the need to establish a framework that provides improved cost and management information that will support better management of Major Defense Acquisition Programs (MDAPs). The Department is already implementing solutions to address the report's recommendations as stated in our detailed responses. The



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**Appendix II: Comments from the Department  
of Defense**

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Department values GAO's feedback and looks forward to continued collaboration to ensure that our efforts are as effective as possible.

Thank you for the opportunity to comment. My point of contact for this effort is Mr. Joseph Quinn. He can be reached at 703-607-0300 x131 or [joseph.quinn@osd.mil](mailto:joseph.quinn@osd.mil).

Sincerely,



Robert F. Hale

Enclosure:  
As stated

GAO DRAFT REPORT DATED JUNE 15, 2010  
GAO-10-695 (GAO CODE 197089)

**“DEPARTMENT OF DEFENSE: ADDITIONAL ACTIONS NEEDED TO  
IMPROVE FINANCIAL MANAGEMENT OF MILITARY EQUIPMENT”**

**DEPARTMENT OF DEFENSE COMMENTS  
TO THE GAO RECOMMENDATIONS**

**RECOMMENDATION 1:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller) (USD(C)); the Under Secretary of Defense (Acquisition, Technology, and Logistics) (USD(AT&L)); and the Military Department Chief Management Officers, as appropriate, to enforce compliance with the Department’s records management policy by periodically evaluating the extent to which the components are maintaining documentation in support of the full cost of military equipment. (See page 19/GAO Draft Report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

In May 2010, the Department issued Financial Improvement and Audit Readiness (FIAR) guidance to the DoD Components requiring that they follow the FIAR Methodology (described in the guidance) when evaluating, testing, and improving their processes, controls, and systems. In accordance with the FIAR Methodology, the FIAR Directorate and DoD Inspector General will evaluate Component compliance with the retention requirements for supporting documentation.

**RECOMMENDATION 2:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to establish and implement ongoing monitoring activities to enforce compliance with the Department’s



existing policies and procedures requiring the components to (1) perform periodic physical inventories and to reconcile the results to property accountability records after completion of existing efforts to verify the reliability of the property accountability records; and (2) track and maintain records for government-furnished property in the possession of contractors. (See page 19/GAO Draft Report.)

**DoD RESPONSE: Concur.**

The Office of USD(AT&L) (OUSD(AT&L)) Property and Equipment Policy Office (PEPO) and Office of USD(C) (OUSD(C)) have developed metrics and are developing additional metrics to monitor compliance with the Department's physical inventory regulations, directives and policies. Further, PEPO and OUSD(C) are currently working with the Components to evaluate compliance with policies, procedures, and internal controls as part of the mission critical asset existence and completeness audit readiness priority.

The Department is also working to define a consistent business process for maintaining records for government furnished property (GFP) in the possession of contractors. OUSD(AT&L)/DPAP issued policies in January 2010 to establish new benchmarks for GFP and to establish requirements for tracking and maintaining records for contractor acquired government-owned property. The FIAR Directorate has established metrics to monitor Component compliance with policies related to tracking and maintaining records for GFP in the possession of contractors in support of validating process controls.

**RECOMMENDATION 3:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to update the Department's guidance regarding verification of information in component property accountability records to include verification that all assets recorded in the accountability records that are required by DoD to have an Unique Item Identifier (UII) are included in its Item Unique Identification (IUID) registry. (See page 19/GAO Draft Report.)

**DoD RESPONSE: Concur.**

OUSD(AT&L) is currently coordinating with the appropriate DoD organizations to make revisions to guidance related to verification of information in property accountability records and the recording of UIIs in the IUID Registry.

**RECOMMENDATION 4:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to develop and implement guidance on how IUID will be used to identify, aggregate, and report asset cost information. (See page 19/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

The Department will use IUIDs to enable the aggregation of managerial cost information across multiple systems based on specific requirements. The cost information will be in management information systems/data warehouses utilizing IUID as the primary key for pulling together the data. The Department plans to implement guidance on how IUID will be captured and utilized to record and report an asset's operational and financial information.

**RECOMMENDATION 5:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to classify the Proper Financial Accounting Treatment for Military Equipment (PFAT4ME) training as a core course for the Department's affected acquisition personnel, including program managers, and track attendance to ensure that personnel required to take the training have done so. (See page 19/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost

information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

PFAT4ME will be recommended as a core course for acquisition personnel that require the training. The Department will determine who needs the training based on the roles and responsibilities of individual acquisition positions. The Department will also track attendance to ensure that personnel requiring the training take the course.

**RECOMMENDATION 6:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to develop and implement guidance to help ensure compliance with the oversight activities for the PFAT4ME initiative, including how often these reviews are to be performed, roles and responsibilities for oversight, the steps to be performed, and the basis for selecting contracts for review. (See page 19 and 20/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

OUSD(C) coordinated with OUSD(AT&L)/PEPO to establish a metric to assess compliance with the PFAT4ME policy. This metric is reported in the semiannual FIAR Plan Status Report. In the next update to FIAR Guidance, the FIAR Directorate will include guidance describing how often Components should perform reviews, Component roles and responsibilities, the steps to be performed by the Components, and the basis the Components should use for selecting contracts for review as part of their ongoing Manager's internal control program.

**RECOMMENDATION 7:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to complete efforts to develop and implement a policy requiring the components to account for the full

cost of military equipment, including guidance for what types of contract and other costs should be included and for determining the appropriate accounting treatment of these costs. (See page 20/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

OUSD(AT&L)/PEPO is working with the Federal Accounting Standards Advisory Board (FASAB) Accounting and Auditing Policy Committee (AAPC) to develop full cost guidance that would be integrated into ERPs and guide cost accounting efforts. When AAPC completes its work, PEPO will develop, coordinate, and issue policy and guidance for accounting for the full cost of military equipment, to include the elements listed in the recommendation above. The Department is sensitive to the cost of obtaining information solely for purposes of proprietary financial reporting and audit, however recognizes that there may be value in cost accounting information that supports better management of MDAPs.

**RECOMMENDATION 8:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to review the Military Equipment Valuation (MEV) methodology business rules to identify inconsistencies and revise the rules as needed. (See page 20/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

After meeting the Department's asset existence and completeness goals, the Department will review the MEV methodology business rules to identify inconsistencies and revise the rules as needed, particularly related to estimating the cost of military equipment, as part of its plans to achieve audit readiness. The Department will consider the recent Statements of Federal Financial Accounting Standards (SFFAS) No. 35 pertaining to the estimation of military equipment historical cost when reviewing the MEV methodology business rules. A cost-effective estimating methodology for the historical cost of older weapon system assets will be pursued if appropriate.

**RECOMMENDATION 9:** GAO recommends that the Secretary of Defense direct the Military Department Chief Management Officers in consultation with the DoD Chief Management Officer; the Under Secretary of Defense (Comptroller); and the Under Secretary of Defense (Acquisition, Technology, and Logistics), as appropriate, to define the component level cost accounting requirements, including how Standard Financial Information Structure (SFIS) data elements will be used to identify, aggregate, account for, and report cost information. (See page 20/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

The Department included appropriate data fields within SFIS to provide a standard cost accounting capability. Within the SFIS data fields, the Department has already defined the standard data elements to aggregate costs managed at the DoD level, such as Major Acquisition Program and Contingency Code. These data fields were collaboratively developed by OUSD(C), OUSD(AT&L), the Business Transformation Agency, and Military Departments.

Data fields in SFIS also provide the Military Departments with the capability to capture and aggregate the costs of programs, projects and activities that they manage. These data fields and business rules are being defined by the Military Departments, as needed, as they deploy new business and financial systems.

After meeting Department objectives for asset existence and completeness, the DoD Chief Management Officer, OUSD(C) and OUSD(AT&L) will work jointly with the

Military Department Chief Management Officers as they define their data element requirements, since these requirements are unique to their mission and information needs.

**RECOMMENDATION 10:** GAO recommends that the Secretary of Defense direct the Military Department Chief Management Officers in consultation with the DoD Chief Management Officer; the Under Secretary of Defense (Comptroller); and the Under Secretary of Defense (Acquisition, Technology, and Logistics), as appropriate, after defining the cost accounting requirements, to utilize the requirements as input to Enterprise Resource Planning (ERP) systems to help ensure that the ERPs will provide the capability to identify and aggregate cost information for the Department's assets in accordance with DOD's defined requirements. (See page 20/GAO Draft report.)

**DoD RESPONSE: Concur.**

The Department has determined that it is not cost-effective to gather auditable data on the historical cost of military weapon systems because the information is not used to manage. We will therefore not invest significant resources in an effort to capture, report, and audit data with no value and will propose appropriate changes in policies and instructions to accommodate this decision. There may, however, be other requirements for cost information related to acquisition program lifecycle management, and we will accommodate those requirements as is appropriate.

The Department's SFIS Governance Board, chaired by OUSD(C), will continue to oversee and work with the DoD Components as they define and implement cost accounting requirements to ensure they develop appropriate managerial cost accounting capabilities in their ERP systems. In addition, the Department will analyze existing ERP functionality requirements against the defined Department-level cost accounting requirements. After completing the analyses, the Department will update the requirements documents to ensure the ERPs are configured to capture and aggregate cost information for the DoD assets.

**RECOMMENDATION 11:** GAO recommends that the Secretary of Defense direct the DoD Chief Management Officer to work jointly with the Under Secretary of Defense (Comptroller); the Under Secretary of Defense (Acquisition, Technology, and Logistics); and the Military Department Chief Management Officers, as appropriate, to assess the Wide Area Work Flow (WAWF) and IUID initiatives and determine the extent to which they will be utilized in the emerging ERP business systems environment. (See page 20/GAO Draft Report.)

**DoD RESPONSE: Concur.**

The Department will assess the WAWF and IUID initiatives and determine the extent to which they will be utilized in the emerging ERP business systems environment.

OUSD(AT&L) has led WAWF and IUID initiatives; has established clear regulatory requirements for IUID and WAWF; and has been scorecarding WAWF and IUID implementation for the last 2 years. As a result of these working groups, the long-term enterprise architecture related to property accountability will be better defined, and the Department will determine the extent to which WAWF and IUID will be integrated into the ERPs for accountability purposes. The DoD Investment Review Board is refining compliance criteria to ensure Automated Information Systems (AIS) compliance includes the ERPs.

Further, the Deputy Chief Financial Officer (DCFO) co-chairs the Investment Review Board that monitors compliance criteria for ERPs. In addition, OUSD(C) works closely with other DoD organizations to address WAWF and IUID issues through working groups (e.g., Procure-to-Pay Working Group, Commercial Pay Council, Tri-Domain Working Group).

**COMMENTS ON THE CONTENT OF THE DRAFT AUDIT REPORT**

Military Equipment Property Accountability Records

DOD plans to complete the verification of the existence and completeness of its military equipment property accountability records in fiscal year 2015. Verification of Component existence and completeness assertions will occur in 2011 for Air Force, 2013 for Navy, and 2015 for Army.

Use of Estimates to Report Costs

Page 4 of the draft audit report includes the following: "Federal accounting standards allow for the use of estimates to report the costs of property, plant, and equipment, if an agency lacks adequate controls and systems to reliably capture the cost of these assets." However, SFFAS 35, *Estimating the Historical Cost of General Property, Plant, and Equipment*, does not limit the use of estimation methodologies when an agency lacks adequate controls and systems to reliably capture the cost of these assets. Rather, SFFAS 35 states "reasonable estimates of historical cost may be used to value G-PP&E assets."

SFFAS 35 amends SFFAS 6 and 23 to clarify that reasonable estimates of original transaction data for historical cost may be used to value G-PP&E. Reasonable estimates may be used upon initial capitalization as entities implement the G-PP&E accounting requirements for the first time, as well as by those entities who previously implemented G-PP&E accounting.

SFFAS 35 also clarifies that agencies should report their G-PP&E based on historical cost information in accordance with the asset recognition and measurement provisions of SFFAS 6, as amended. However, reasonable estimates of historical cost may be used to value G-PP&E assets. SFFAS 35 also allows the use of reasonable estimates when an entity determines it is necessary to revalue G-PP&E assets previously reported.



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# Appendix III: Documentation Reviewed to Identify Weaknesses That Impair DOD's Ability to Identify and Account for the Cost of Military Equipment

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**Appendix III: Documentation Reviewed to  
Identify Weaknesses That Impair DOD's  
Ability to Identify and Account for the Cost of  
Military Equipment**

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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Acknowledgments

In addition to the contact person named above, key contributors to this reports were Evelyn Logue, Assistant Director; Vanessa Estevez; Maxine Hattery; John Lopez; Chris Martin; Heather Rasmussen; Darby Smith; and Omar Torres.



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